

CHAPTER 9 CHINA

Introduction. Although China exhibits remarkable economic growth, its weak financial system threatens long-term stability. China's accession to the World Trade Organization (WTO) promotes further economic growth, although several sectors like banking and state-owned enterprises (SOEs) find it difficult to adapt and become more efficient.

The Good, the Bad, and the Uncertain

Good News. At first glance, China appears to be on a roll.

- China's economic performance is reportedly the strongest among the world's larger countries.
- Foreign exchange reserves are robust.
- In July 2001 China was awarded the 2008 summer Olympic games, another shot in the arm to the economy down the road.
- In September 2001, China's WTO entry became a "done deal," with a quick Chinese ratification expected and entrance as early as the end of 2001.
- In October 2001 Shanghai hosted the Asia Pacific Economic Cooperation (APEC) forum, which attracted virtually all Asian political and economic leaders.
- In short, China is relishing their new international recognition, respect, and apparent economic power.

Bad News. Numerous negative economic trends heighten Beijing's anxiety.

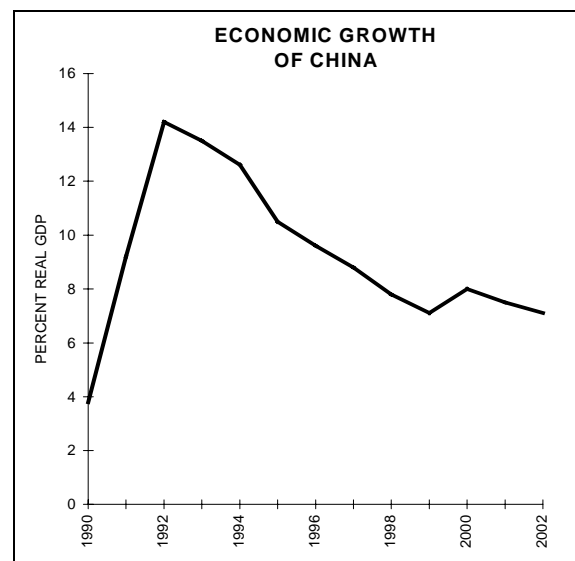
- Prior to 9-11, the global economic slowdown was triggering a severe slowdown in Chinese export growth.
- The terror attacks on the United States threw the United States and the rest of the major world economies into recession, or at least a severe slowdown.
- A weak global economy will hurt Chinese export performance.
- It will also curtail the flood of incoming foreign direct investment—notwithstanding WTO entry.

Figure 9-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	1055.4	928.9	980.2	1080.0
Purchasing Power	3770.0	3988.3	4112.2	5023.2
Real Growth (%)	8.8	7.8	7.1	8
Inflation (%)	2.8	-0.8	-1.4	0.4
Exports	182.8	183.8	195.0	249.2
To U.S.	65.8	75.1	86.5	106.2
Imports	142.4	140.2	165.7	225.1
From U.S.	12.8	14.3	12.9	16.0
FDI from U.S.	5.0	6.3	8.1	9.6
In U.S.	0.2	0.3	0.3	0.3
Cur Account /GDP %	2.2	0.9	1.6	1.9
Fiscal Balance /GDP %	-0.8	-1.2	-4.1	-2.6
External Debt /GDP %	16.5	16.6	15.9	

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 9-B



- As the external economic drivers weaken, pressure increases for Beijing to transform its fragile domestic financial underpinnings before they crack.

On the Brink. China stands on a threshold.

- On the one hand, WTO entry may be just the catalyst Beijing needs to catapult to a market economy across the board. But that's a huge leap. In this regard, WTO entry will be a gut wrenching transformation that could easily get out of control.
- China's financial system—one of the weakest in Asia—makes the transition especially difficult. If mismanaged, China's WTO entry could trigger Chinese social unrest, financial chaos, and political instability for China's fourth generation of political leadership.

Economic Miracle. For almost three decades China's export-led growth strategy appears to be an economic miracle:

- China is now the seventh largest economy in the world. Despite the U.S. and global economic downturn, China's GDP performance continues to be the strongest among the world's larger countries.
- GDP expanded on average 9.7% from 1980 to 2000. Economic growth was 7.1% in 1999 and 8.0% in 2000. In the first half of 2001, GDP reportedly grew 7.9%.
- Foreign exchange reserves stood at an impressive \$193.5B as of 15 September 2001. Chinese Premier Zhu Rongji says that foreign exchange reserves should reach \$200B by the end of the 2001.

Cooked-Up GDP. But all of these growth figures must be taken with a grain of salt.

- A February 2002 Chinese National Bureau of Statistics discovered 60,000 statistical violations, thus confirming Zhu Rongji's criticism of the statisticians for cooking the books to meet high GDP targets.
- PRC GDP also reflects "phony production" of SOE goods nobody wants—a huge oversupply avoided in market economies.

Low Baseline. China's growth numbers also look good because the economy was so backward to begin with back in 1979. The communists left it in ashes. Economic growth rates therefore look dramatic because the starting baseline GDP was so low.

Pockets of Poverty. Moreover, while coastal areas of China are relatively prosperous, large sections of interior China still remain desperately poor.

- The gap between rich and poor is now among the highest in the world.
- The closure of SOEs has impoverished many.
- There are 120 million people living below the poverty line and around another 150 million seasonally-employed migrant workers.
- And if one considers China's huge population, China tumbles down the country rankings to about number 150 as measured by GDP per capita.

Economic Drivers

Now let's turn to the major factors driving Chinese economic growth. All are faltering. These drivers include:

- Export Growth
- Foreign Direct Investment (FDI)
- Government Spending

Not an Island. China used to be considered an economic island immune from the ups and downs of the global economy. Not anymore. China's stakes in the global economy are high.

- Trade and investment now contribute more than 40% to China's GDP.
- One-fifth of China's exports go to each of the United States and Japan, both of which are struggling with an economic slump.
- Consequently China's growth is vulnerable to the U.S. and Japanese recessions that also threaten the rest of the world with recession or anemic growth.
- Weaker Asian growth—due to debt overhangs, high oil prices, and weaker demand for Chinese computers and consumer electronic exports—further weaken demand for Chinese exports.

Trade

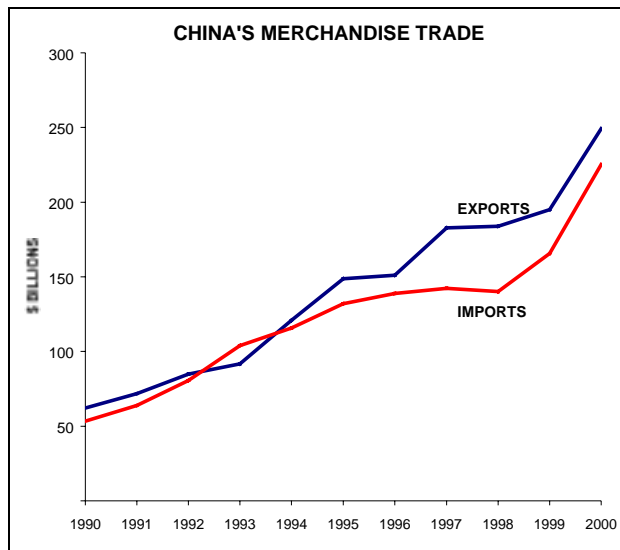
Exports Falling. In this regard, Chinese export led growth—while still a source of demand—is starting to lose its punch in late 2001.

- For the eight months to August 2001, Chinese exports worldwide only rose 7.3%, compared to a 34.6% increase over the same period last year.
- Terrorist attacks on the United States on 11 September accelerated the downward trend in export growth.

Falling Trade Surplus. Faltering Chinese exports are hammering the trade surplus. China is now experiencing the smallest trade surplus since 1996. (See Figure 9-D.)

- For instance, the trade surplus in August 2001 was \$1.38B, down by nearly 50% from \$2.54B a year earlier, after exports showed a mere 0.9% increase.
- The trade surplus of \$11.45B in September 2001 fell 32% from a year earlier.

Figure 9-D



Export Promotion. Beijing has pledged to employ "1,000 plans and 100 stratagems" to boost exports in 2001 and 2002. Unfortunately, the policy options seem limited.

- During the Asian crisis, it awarded successively larger value-added tax (VAT) rebates to exporters to offset a fall in their price competitiveness. But now VAT is rebated for exporters at an average of 15% of the maximum 17%, leaving only 2% available for further rebates. The government has been reluctant to further boost rebates, partly because of a huge fraudulent rebate claims scandal that emerged during the Asian crisis.
- Indeed, there are only a few alternatives:
 - One is to provide approvals for more private companies to export directly—cutting out export agents that reduce efficiency and charge significant fees.
 - Another is to assist exporters in identifying new markets away from the United States and Japan.

Devalue? China's faltering export performance rekindles the ongoing debate over whether China needs to devalue its currency to boost export competitiveness. But, as in previous years, there are several reasons not to devalue. China may be keen on claiming the international kudos it won during the Asian crisis for refusing to devalue despite clear pressures on exports.

Rising Imports. China's faltering trade surplus reflects rising imports as well as falling exports. Why are imports going up?

- Imports into China are surging as domestic companies prepare for the post-WTO competition by upgrading plants and machinery.
- China's robust demand for imports will be reinforced by WTO entry because falling tariffs will trigger a flood of imports.

Possible Capital Flight. Chinese import inflows and capital flight are related.

- Imports put pressure on Beijing to devalue to make Chinese exports cheaper.
- People & companies inside China, fearful of devaluation, may move money out of the country, thus making devaluation a self-fulfilling prophecy.

Imports and Layoffs. Imports may also trigger a flood of layoffs.

- Lay-offs over the next five years could amount to 20% of SOE workforce.
- WTO entry will make reform of industrial and financial sectors more urgent as markets open to foreign competition.

Foreign Investment

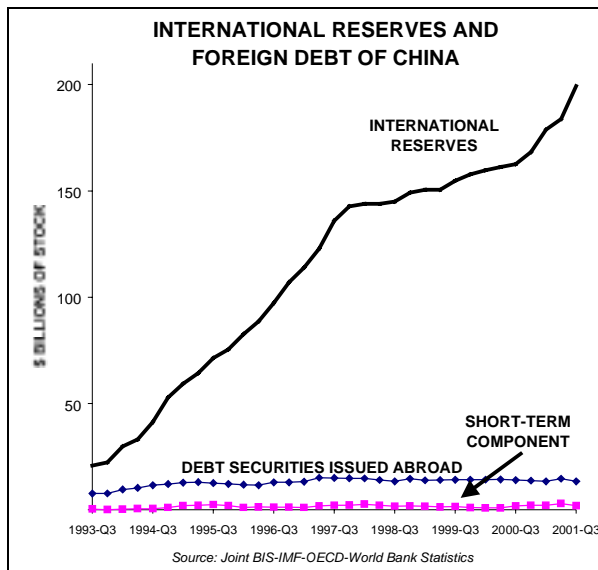
Rise of FDI. Back in 2000 FDI was pouring into China. The spike-up in FDI reflected investor frustration with slow reforms in ASEAN economies. China was winning "head to head" FDI competition with ASEAN.

- China received 61% of the FDI coming to developing Asian economies, in contrast to just 18% a decade ago.
- In contrast, ASEAN economies received just 17% of FDI that flowed to developing countries in Asia, down from around 61% in the early 1990s. Obviously China was doing something right.
- No other Asian country could match the potential of China's vast home market, its huge pool of low-cost labor, and its growing class of educated technocrats.

Fall of FDI. The tables may now be turning—at least in the short run. FDI is no longer pouring into China. Why not?

- The U.S. recession, coupled with a host of new fears stalking corporate America, is expected to delay several of the overseas investment plans of American corporations.
- In addition, the 9-11 terrorist attack on the United States is having a negative impact on FDI coming into China.
- In the longer term, it is the damage to China's expectations of a flood of inward investment following its accession to the WTO that could be set back the most by the terrorist attacks.
- As cited earlier, foreign investment and trade together account for over 40% of China's GDP. So a significant decline in both could jeopardize China's rapid growth.
- Foreign debt is moribund despite healthy international reserves. (See Figure 9-E.)

Figure 9-E



Private Domestic Demand?

Demand Doldrums. Let's turn first to whether or not China can offset these negative external shocks with stronger, domestically-driven demand. The prospects of China generating homegrown, self sustaining, high-quality economic growth are not good. Why? In healthy market economies, private sector demand drives most of the economic activity. But in China, consumer spending growth has been near zero for many years. Why is private demand in China so weak?

- In rural areas, the growth of rural incomes has also slowed dramatically.
- 100 million unemployed rural workers & 18 million unemployed urban workers don't spend much money.
- Millions of other Chinese are worried about losing their jobs.
- Even those workers with job security face crushing, new bills due to rising costs in housing, education, and health care.

Saving Too Much. In the face of uncertainty, Chinese households save rather than spend.

- From 1992 until 1995, the Chinese consumers spent 78% of their earnings and saved 22% of earnings.
- In recent years, Chinese consumers have spent only about 60% of their earnings and saved 40% of earnings.

Consumption Incentives Fail. In hopes of boosting sluggish consumption, Beijing has tried a number of things. Beijing resorted to lower interest rates, disincentives for savings, lower taxes, higher wages, welfare handouts, and increased provision of consumer credit. None have been terribly effective.

Price Deflation. Reluctance of consumers to spend has been one of the main reasons for the price deflation since October 1998. Over-capacity and oversupply are also worsening deflation.

- Beijing has taken administrative actions to curb price deflation. These socialist tactics include administrative adjustments in service sector prices for education, health care, housing rentals, and water.
- But in the private sector the prices of food, clothing, building materials, consumer electronics, and manufactured goods continue to show disturbing declines.

Government Spending

Government Overspending. In hopes of offsetting the fall in private demand and maintaining high levels of growth, Beijing has opted for stop-gap spending. In fact, for the last four years, the main engine of GDP expansion has been a huge, increasingly controversial fiscal stimulus program.

- The government appears committed to continue infrastructure projects financed from state coffers and state bank lending.
- China has had considerable difficulty servicing its current high levels of public debt.
- And yet Beijing plans still another fiscal stimulus above and beyond the Rmb150B planned for 2002.
- Unfortunately, this kind of year-after-year over-spending weakens China's fragile underpinnings and is unsustainable.

Financially Unstable Government. Publicly, the government claims its finances are viable.

- For instance, official figures show domestic debt at only 15% of GDP. But this is creative accounting at its worst.
- If contingent liabilities in the form of bad debts in state banks, unfunded state pensions, and social welfare liabilities are counted, public sector debt levels quickly climb to near 100% of GDP.
- If the Maastricht rule of thumb is applied—that public sector debt over 60% of GDP is financially unstable—it's clear that China's public finances are dangerously high and unsustainable.
- In other words, China's so-called economic power rests on financial quicksand.

Banking

Mountain of Non-Performing Loans (NPLs).

The greatest structural weakness in the Chinese economy is the level of NPLs in the domestic banking system. In this regard, the balance sheet of the state run banks looks even worse than the government's fiscal balance sheet.

- In fact, the Chinese state-run banking sector is one of Asia's weakest.
- According to Beijing, the NPL ratio of the Big Four state banks is 30% of assets.¹ More objective private financial analysts say NPLs represent 50% of the total assets of the Big Four banks. Even using the more conservative official figure for NPLs, credit rating agencies such as Fitch IBCA and Moody's say the Big Four state banks are technically insolvent.

- Since the Big Four banks account for around 80% of total assets in the domestic financial system, such fragile underpinnings pose a serious crisis of confidence in the country's biggest banks.

Bank Bailouts. Beijing is well aware of the negative impact that its mountain of bad loans has on the financial system and the wider economy. In fact, the central bank is pursuing the Herculean task of clearing up the system and strengthening the Big Four.

- The government issued Rmb270B in bonds to bolster bank capital in 1998.
- It is also the implicit guarantor of Rmb1,400B in bonds issued by four Asset Management Companies (AMCs) that took an equal amount of NPLs off the books of the Big Four in 1999 and 2000.
- But how long can China keep these bail-outs going? When is the day of reckoning?

Banking Crisis? Chinese officials tend to dismiss such fears of a banking crisis. They say the risk of a banking crisis is rendered remote because all the Big Four banks are owned by the finance ministry and enjoy an implicit sovereign (government) guarantee. But actually, government guarantees provide little comfort. Why not?

Government Tapped Out. We've seen that the government is also over-borrowed and faces a severe fiscal crisis. The Chinese government is in no position to keep spending the kind of money needed to indefinitely bail-out the state run banks. The Big Four banks cannot keep pouring money down the rat's hole of SOEs that insist on their right to destroy the savings of the Chinese people.

- Even if the government could come up with the capital, the bank bailouts create a moral hazard. Bank bailouts encourage more-and-more reckless loans from the state run banks to the sick and inefficient SOEs.

Slows Bank Reform. In addition, the financially weak state-run banks are frustrating the course of financial liberalization and banking reform. Why?

- If the Big Four banks are subjected to free market competition too early, Beijing fears they will lose deposit and loan business to domestic and foreign competitors.
- The Big Four banks also risk collapsing under the sheer weight of their bad debts.

Financial Dithering. For this reason, financial reforms are being implemented incrementally—and those that are considered too risky are diluted or put off.

- For instance, a move unveiled last year to liberalize interest rates within three years has been delayed. Yet China cannot hope to create a functioning domestic bond market until interest rates are free.
- Without a discernible yield curve, a host of other financial instruments that could be used to hedge currency risk cannot be launched.

Political Credit. Most importantly, the current system of virtually fixed interest rates tends to perpetuate what is one of the world's worst allocations of credit.

- In this regard, two-thirds of credit resources go to loss-making SOEs that generate only one-third of industrial output.
- The inability of banks to price for risk also prevents loan officers from developing risk assessment skills.
- These weak banking skills impede the flow of funds to more dynamic private sectors.

State vs. Private Banks. Beijing also continues to show favoritism to state run banks over private banks.

- For instance, a plan to allow the establishment of several new private domestic banks has been quietly dropped.
- The pace of opening commerce to private foreign banks has also fallen back.

Slow Progress in Sell-offs. Beijing hopes the AMCs can eventually sell NPLs to foreign or local investors in return for assets in the companies that ran them up. Unfortunately, progress in sell-offs has not been encouraging.

- Legal snags over foreign property rights serve to discourage foreign investors.

- Meanwhile, the longer the AMCs fail to find revenue by selling off SOE assets, the longer the AMCs remain a burden on the central bank.

Bad News: Fiscal Crisis

To make matters worse, China faces an alarming list of future spending demands. These include:

- Standing up a costly welfare/unemployment system to accommodate rural unemployment.
- Creation of an expensive pension system for an aging population (90 million people over 65 by 2003).
- Sharply increasing infrastructure spending that is required for developing the impoverished western part of the country.
- Re-capitalizing state banks that are collapsing because of a mountain of NPLs, that in turn are due to loss making SOEs that continue to suffer from over-production.

In the past, Beijing has tried to use a combination of taxation and government controlled capital markets to finance much of its public spending requirements. But this approach is proving increasingly ineffective.

- Total government debt is now five times what it was in the middle of the 1990s.
- As a result, China is struggling to service its current level of public debt.

Way Out: Bonds. Beijing now realizes that these looming spending demands require a new approach. While the public financial shortfall cited above undoubtedly reflects insufficient tax revenue, Beijing would be ill advised to try to fill the gap with simply higher taxes. That would only worsen the macroeconomic problem of insufficient consumer demand in the economy.

- To reduce the burden on the consumer and minimize price deflation, Beijing must create a liquid bond market that would facilitate the issuance of long-term government debt.
- Beijing should opt for long term interest rates determined in a western style bond market (rather than by the central bank).

- In other words, Beijing should carefully weigh the financial advantages of surrendering government control of capital markets and pursuing true capital market reform based on supply and demand for long-term government debt.

Exploiting the Internet

Chinese access to an open Internet is also a key to Chinese prosperity in a global economy. Jiang Zemin, China's president, can take some pride from Beijing's "Silicon Valley," filled with high tech "whiz kids."

- This catalyst has propelled an explosion of Internet users in China. Subscriptions are up 14-fold to 8.9 million.
- China will soon be the world's biggest market for telecommunications equipment.
- Global IT promises to unleash the full economic potential of China.

Striking a Balance. Beijing leaders need to carefully weigh how to address the Internet in a Chinese social and political context.

- Total Internet freedom maximizes China's long term economic potential.
- But too much Internet freedom could also be destabilizing and threaten Beijing's political authority.
- Perhaps the best approach is for Chinese leaders to strike a balance: Continue to embrace the Internet, but steer it toward an orderly, acceptable combination of economic growth and social stability.

Conclusions

Weighing Options. China stands at the brink. It can either strengthen its economic security. Or it can crash and burn. Which broad economic course of action is appropriate for China? The following are some economic options that China needs to carefully consider:

- The first option would be to strengthen regulatory defenses. But can China remain unscathed, safe behind its self-imposed regulatory barriers? Just as the bricks of the Great Wall were unable to protect the Middle Kingdom from the hordes, so its regulatory and legal walls will not completely save it from global capitalism. Thus, the answer to China's economic

woes must not be to rely merely on such regulatory defenses.

- The second option is neo-Maoism. Should China go back to the days of Mao? Should it revert back to the past economic and political practices, reversing free-market reforms and moving back to a more command-oriented economic model? Frankly, there are leftist forces that think this would be a good idea. But not many.
- The third option is to opt for a "total" free market. In fact, many observers in the West say China must opt for this kind of "shock therapy." These analysts do not seem to understand the following reality: Were it not for the fact that the renminbi is not yet convertible on capital account, China's banking system would have melted down during the Asian economic crisis. It would arguably melt down today as well. This COA would cause China to go the way of Indonesia and Thailand amid a mountain of bad debts and over-leverage, the results of decades of politically driven credit policies.² Thus, the "instant free market conquers all" analysts—who call for full, immediate, unfettered liberalization of the financial markets in China—are ill-advised.

Institutional Reforms. The best economic option for China is to conduct measured economic reforms to strengthen economic security. This option involves increasing and broadening the reforms from within. China needs to improve the internal economic and financial structure. China also needs to become better able to deal with free-market forces. At the same time, China needs to maintain at least some economic defenses until its financial institutions are strong enough to fully withstand the relentless forces of global capitalism. In short, China needs to develop commercial and investment bankers trained and ready for financial battle.

Endnotes

1 NPLs over 20% of total assets place a bank in the alarm zone. Healthy U.S. banks have NPLs that are in the single digit category. The Big Four banks are the Industrial and Commercial Bank of China, the Bank of China, the Agricultural Bank of China, and the China Construction Bank.